82-SBE-036

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
VON HOUSEN MOTORS)

For Appellant: James W. Pomares
Certified Public Accountant

For Respondent: Jeffrey M. Vesely
Counsel

Kendall E. Kinyon
Counsel.

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Von Housen Motors against a proposed assessment of additional franchise tax in the amount of $21,419.25 for the income year ended May 31, 1974.

The issues for determination are the following: (i) Is respondent's proposed assessment, based upon a final federal determination of appellant's federal tax liability, entitled to a presumption of correctness as to issues of fact; (ii) Was appellant entitled to claim as depreciation amounts representing the reduction in wholesale value of its leased vehicles; and (iii) Did appellant's manner of depreciating its leased vehicles constitute an "erroneous method of depreciation" so as to allow it to retroactively adopt a proper method of depreciation for the year in issue.

Appellant was incorporated under the laws of the State of California on June 16, 1961. Its principal business activity is the operation of a Mercedes Benz automobile agency in Sacramento. In addition to retail sales and service, a substantial portion of appellant's business involves the leasing of Mercedes Benz automobiles. The subject of this appeal is the depreciation allowance claimed by appellant for those leased vehicles during the year in issue.

A federal audit of appellant for the income years ended May 31, 1972 and 1973, determined that the depreciation allowances claimed by appellant with respect to its leased vehicles were erroneous. Appellant alleges that its method of depreciation was based solely upon reductions in market value of its leased automobiles as determined through use of the Kelley Blue Book. The federal audit revealed, however, that appellant calculated its depreciation allowance through a combination of straight-line depreciation and, in addition thereto, a so-called "valuation write-off" on almost all of its leased vehicles. Specifically, the IRS determined that the cost of each leased vehicle, less its salvage value, was prorated equally on a monthly basis over the life of the lease, commencing with the month in which the lease commenced. Through use of this straight-line depreciation method, appellant was able to determine the annual depreciation of its leased vehicles. The federal audit further determined that in addition to the depreciation allowance determined in accordance with the straight-line depreciation method, appellant also separately valued each leased vehicle and deducted as depreciation an additional year-end "valuation write-off" on virtually all of its leased vehicles. On both its federal and state returns, appellant claimed a single depreciation deduction which, as noted above, the Internal Revenue Service determined was composed of the combined total derived from straight-line depreciation and the year-end "valuation write-off." The federal audit indicated that, in many instances, appellant's manner of depreciation resulted in the reduction of the vehicles' bases below salvage value and that many of the deductions claimed on individual vehicles were in excess of the 200 percent which the declining balance depreciation method would have provided.

For both of the years which were the subject of the federal audit, the Internal Revenue Service allowed that part of appellant's depreciation deduction computed pursuant to the straight-line method of depreciation. That component of appellant's depreciation deduction which the IRS determined was attributable to the "valuation write-offs" was disallowed. In arguing against the IRS's actions, appellant relied principally on its contention that its manner of depreciation constituted an "erroneous method of depreciation" which, having been disallowed, permitted it to adopt a proper method of depreciation pursuant to Revenue Ruling 72-491, 1972-2 Cum. Bull. 104. The Internal Revenue Service rejected this position, contending that appellant's adoption of the straight-line depreciation method was proper and that it was not disallowing an erroneous method of depreciation. The IRS concluded that the "valuation write-offs" were unallowable loss deductions due to shrinkage in market value which had been improperly labeled as depreciation by appellant.

In November 1975, respondent issued proposed assessments for the 1972 and 1973 income years based entirely on the federal adjustments. Appellant, after agreeing to a federal settlement proposal for years 1972 through 1975, which allowed appellant investment tax credits, but which sustained the depreciation adjustments for 1972 and 1973 and further required appellant to file its federal returns for 1974 and 1975 in accordance with those adjustments, agreed to respondent's proposed assessments for 1972 and 1973 and paid the deficiencies.

In 1977, appellant's 1974 and 1975 federal returns were audited. For 1974, the Internal Revenue Service again disallowed that portion of appellant's depreciation deduction which reflected "valuation write-offs." Appellant did not deduct the "valuation write-offs" as depreciation in 1975. The federal audit indicated that a deduction in the amount of $326,320 was disallowed as being attributable to the erroneous "valuation write-offs." Using the same reasoning employed with respect to the 1972 and 1973 depreciation adjustments, the Internal Revenue Service permitted appellant to compute its depreciation deduction for 1974 pursuant to the straight-line method. Appellant, which contends that federal net operating loss and investment tax credit carryback provisions would have resulted in increased federal tax liability had it successfully contested the depreciation issue, agreed to the federal depreciation adjustments for 1974, However, it protested the proposed assessment issued by respondent, which was based entirely upon the agreed federal adjustments, contesting the disallowance of the deduction for the "valuation write-offs." After consideration of appellant's arguments, respondent affirmed its proposed assessment, thereby resulting in this appeal.

Initially, we note that a deficiency assessment issued by respondent on the basis of a federal audit report is presumed to be correct as to issues of fact, and the burden is on the taxpayer to prove that which is necessary to upset respondent's determination. (Todd v. McColgan, 89 Cal.App.2d 509 [201 P.2d 414] (1949); Appeal of Jackson Appliance, Inc., Cal. St. Bd. of Equal., Nov. 6, 1970; Appeal of Western Orbis Company, Cal. St. Bd. of Equal., Aug. 1, 1974.) In opposition to this principle, appellant maintains that it agreed to the federal adjustment without admitting to the validity of the deficiency which gave rise to the adjustment. Appellant asserts that, because of federal carryback provisions, its federal tax liability would have been substantially increased had it successfully contested the issue. Regardless of what motivated appellant's agreement with the Internal Revenue Service's determination regarding its depreciation deduction, the fact remains that it did agree to the adjustment. In analogous appeals, where the taxpayers allegedly agreed to federal adjustments which did not result in substantial federal tax liability because of net operating loss carrybacks, we held that the presumption of correctness attached to the assessment. (Appeal of Western Orbis Company, supra; Appeal of Jackson Appliance, Inc., supra.) Consequently, as appellant has not furnished the evidence necessary to establish that its depreciation deduction was not a combination of straight-line depreciation and, *valuation write-offs," we are required to conclude that respondent's determination as to this issue of fact was correct.

While it is well settled that respondent's determinations as to issues of fact are presumed to be correct, and that the burden of providing the evidence necessary to upset such findings rests with the taxpayer, it is equally well established-that no such presumption is appropriate as to questions of law. As to such issues, respondent's determinations, whether they be based upon a federal audit or otherwise, have no presumptive validity; (Carrano v. Commissioner of Internal Revenue, 70 F.2d 319 (2d Cir. 1934).) Accordingly, the issue of whether appellant's manner of depreciation was proper must be discussed on its own merit.

Appellant notes that Revenue and Taxation Code section 24349, subdivision (b)(4), permits the depreciation allowance to be computed through use of "any ... consistent method productive of an annual allowance" which does not exceed the depreciation allowance calculated pursuant to the declining balance method provided in subdivision (b)(2) of that section. Appellant asserts that the manner of depreciation it-employed for the year in issue was proper since, as required by respondent's regulation 24349, subdivision (k)(2), it set aside an amount for depreciation in accordance with a reasonably consistent plan. Further, appellant claims that its depreciation allowance for the year in issue did not exceed the amount allowable under the declining balance method. Finally, appellant contends that as there exists no convincing basis for a change in its depreciation deduction for the year in issue, its deduction should be allowed to stand. (See Cal. Admin. Cods, tit. 18, reg. 24349, subd. (k)(l).) After a careful review of the record on appeal, and for the specific reasons set forth below, it is our opinion that appellant improperly calculated the amount of its depreciation allowance for the year in issue.

Appellant claims that its "valuation write-off" plan of "depreciation" is proper because it accurately attributed a market value, based on the Kelley Blue Book, to each of its leased vehicles. Section 24349 of the Revenue and Taxation Code provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in trade or business shall be allowed as a depreciation deduction. (See also Cal. Admin. Code, tit. 18, reg. 24349, subd. (a)(l).) The depreciation deduction cannot reflect amounts representing a mere reduction in, or fluctuation of, market value. (The Farmers Grain Co.', 1 B.T.A. 605 (1925);

Louis Titus, 2 B.T.A. 754 (1925).) Since appellant's depreciation deduction admittedly reflected amounts representing a mere reduction in, or fluctuation of, market value, we must sustain respondent's disallowance of that portion of appellant's depreciation deduction representing such "valuation write-offs."

As noted above, respondent's determinations as to issues of law have no presumptive validity., (Carrano v. Commissioner of Internal Revenue, supra.) Consequently, we are not bound to accede to its finding, based upon a federal audit, that appellant did not originally adopt an "erroneous method of depreciation," thereby precluding it from retroactively adopting a proper method for the year in issue.

In Silver Queen Motel, 55 T.C. 1101 (1971), the United States Tax Court held that when the taxpayer had erroneously attempted to use the double declining balance method of depreciation for used assets, and the IRS disallowed such use for the first year for which the taxpayer attempted to use the improper method, then the taxpayer was permitted to "adopt" any permissible depreciation method, and was not limited to the use of the straight-line method. The court held that' the taxpayer's change of depreciation method did not require the consent of the Commissioner of Internal Revenue since the taxpayer had not regularly computed its depreciation deduction under the improper method because the Commissioner had denied it that choice in the first instance, i.e., the first year of its attempted use of the unacceptable method. Similarly, in Robert M. Foley, 56 T.C. 765 (1971), the Tax Court held that when a taxpayer used an improper depreciation method (double declining balance) in the year of asset acquisition and, in an amended return for such taxable year, which was filed prior to filing the return for the succeeding taxable year, adopted a proper depreciation method (150 percent declining balance), such "adoption" invalidated the original election, and the taxpayer was permitted to adopt for the first tax year the 150 percent declining balance method. As in Silver Queen Motel, supra, the court based its decision on the fact that the taxpayer had not regularly used the unacceptable method of depreciation and therefore was not precluded from adopting a proper method.

In view of these two decisions, the IRS determined that when a taxpayer has attempted to use an erroneous method of depreciation: (i) if, as in Silver

Queen Motel, supra, the IRS disallows the use of an improper depreciation method for the first taxable year for which the taxpayer attempts to use the method and thereby prevents its adoption, the taxpayer may adopt the straight-line method, or any other method of depreciation that would have been permissible had it been adopted initially by the taxpayer; and (ii) if, as in Robert M. Foley, supra, the taxpayer filed his first return using an improper method of depreciation, and subsequently, but prior to the time the return for the succeeding taxable year is filed, files an amended return using a proper depreciation method, the use of the proper method is permissible without obtaining the consent of the Commissioner of the Internal Revenue Service. (Rev. Rul. 72-491, supra.)

Appellant maintains that its utilization of straight-line depreciation and "valuation write-offs" constituted a method of depreciation which, upon a finding that it was improper, constituted an "erroneous method of depreciation." Accordingly, appellant contends, it should be allowed to retroactively adopt a proper method of depreciation for the year in issue. As previously observed, the IRS considered and rejected an identical argument raised by appellant with respect to the federal adjustment of appellant's 1972 and 1973 depreciation deductions. Respondent, in reliance upon the same reasoning employed by the IRS with respect to that audit, determined that appellant should not be permitted to retroactively adopt another proper method of depreciation for the year in issue. In essence, respondent asserts that the depreciation approach utilized by appellant was not a method of depreciation to the extent that one of its two components (i.e., the "valuation write-off") was not in fact a measure of depreciation. Consequently; respondent continues, as the only allowable component of appellant's method was straight-line depreciation, appellant's method of depreciation was in fact a proper one. Therefore, since a taxpayer who adopts an acceptable method of depreciation on its original return may not, in a later taxable year, retroactively change to another acceptable method (Rev. Rul. 74-154, 1974-1 Cum. Bull. 59; Clinton H. Mitchell, 42 T.C. 953 (1964)), respondent maintains that appellant should not be allowed to change its method of depreciation as its original "election" of straight-line depreciation was one of an acceptable method.

After careful consideration of the final issue presented by this appeal, we must conclude that appellant's utilization of straight-line depreciation in combination with the so-called "valuation write-offs" did not constitute an erroneous method of depreciation. Appellant's manner of "depreciation" was composed of two components, only one of which, i.e., straight-line depreciation, constituted a reasonable allowance for the exhaustion, wear and tear, and obsolescence of its leased vehicles. The "valuation write-off" component, as previously noted, merely represented reductions in, or fluctuations of, market value and, as such, did not constitute depreciation. Therefore, to the extent that appellant's plan constituted a method of depreciation, it consisted of only one component: straight-line depreciation. Accordingly, we mustsustain respondent's determination that appellant's method of depreciation was a proper one and that it is precluded from retroactively changing to another acceptable method. (Clinton H. Mitchell, supra.)

For the reasons set forth above, respondent's action in this matter will be sustained.

Appeal of Von Housen Motors

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Von Housen Motors against a proposed assessment of additional franchise tax in the amount of $21,419.25 for the income year ended May 31, 1974, be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day of March, 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Reilly, Mr. Dronenburg, Mr. Nevins and Mr. Cory present.

William M. Bennett, Chairman

George R. Reilly, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Kenneth Cory, Member